THE RIGHT TIME *for* RESEARCH

Illustration: Robert Meganck, Communication Design, Inc.

Decoupling investment banking from sell-side research has created a niche for truly independent research.

BY JACK MILLIGAN

George Washington, whose majestic statue towers over Wall Street from the steps of Federal Hall in lower Manhattan, observed how "few men have sufficient virtue to withstand the highest bidder." Old George turned out to be pretty darned prescient about the neighborhood. In an effort to protect the virtue of equities research on Wall Street, the Securities and Exchange Commission (SEC) has practically reinvented it. And the greatest beneficiaries may be the small, independent firms that sell their research directly to investors.

A landmark agreement between the SEC and 10 major securities firms that were embroiled in an embarrassing conflict-of-interest scandal requires, among other things, a severing of all links between research and investment banking. In part, this means that equities research departments may no longer be subsidized by their firm's investment banking group, inevitably leading to smaller staffs at the large Street firms.

"I think you'll see more independent research and less Wall Street research," says Bruce Gulliver, CFA, president and chief investment officer at Jefferson Research & Management in Portland, Ore., USA. "I expect the independents to get a bigger slice of the business."

The equities research departments at major securities firms produce no direct revenue. Instead, they are subsidized by profit centers within the firm — with the largest contribution typically coming from the investment-banking side of the house. This results in a potential conflict of interest between the obligation of analysts to provide investors with fair, unbiased, and sometimes critical research — and the expectation that they will help investment bankers win new business assignments or, at the very least, not impede their efforts.

"The ultimate problem is that [Street firms] don't make money selling research, and they make a lot of money in investment banking," says Tom Brown, president of New York-based hedge fund Second Curve Capital — and a one-time sell-side equities analyst who ran afoul of the bankers at his former firm. (See side story, p. 37.)

Unfortunately, the research practices at prominent Wall Street firms turned out to be less than virtuous as highlighted by a number of highly publicized scandals in recent years. Although it was not unheard of for analysts to be pressured not to downgrade the stocks of a good corporate client or potential client, the conflict-of-interest problem boiled over during the Internet boom of the late 1990s when investment bankers were busy courting all the new companies then going public. New York Attorney General Eliot Spitzer — and later the SEC — accused analysts at major sell-side firms such as Salomon Smith Barney Inc. and Merrill Lynch & Co. of hyping the stocks of various Internet companies even though they knew — based on internal e-mails — that their prospects did not justify such bullish recommendations. The collapse of many Internet and telecommunications stocks in 2000 left retail and institutional investors alike with billions of dollars in losses.

In December of last year, the agency announced a "global settlement" with the 10 largest securities firms in the United States — and individual fines totaling US$900 million. Among the agreement's conditions were a complete separation of research and investment banking, including a ban of the practice of having analysts accompany bankers on sales pitches and road shows with potential corporate clients. The firms also will have to publicly disclose their analyst recommendations and price target forecasts. And over the next five years, each firm is required to contract with at least three independent research firms to provide research to their retail clients. The total commitment of all 10 firms is US$450 million.

AIMR has proposed its own research objectivity standards. Like the SEC, the organization also wants research to be segregated from investment banking, and to see analysts' compensation aligned with the quality of their work and the accuracy of their recommendations. (See proposed standards at www.aimr.org/standards.)

The separation of research from investment banking inevitably will result in smaller equities research staffs at the major brokerage houses. Equities research is still a vital activity to these firms. It provides guidance to their retail brokers, coverage for their corporate clients, and the kind of thought leadership that can bring in institutional investors. It's highly unlikely that a large company would steer any of its investment banking business — whether it's raising capital or handling an M&A assignment — to a Street firm that didn't cover its stock. But research is also a cost center, and one that may need to be rationalized.

Deprived of a fat investment-banking subsidy, Street firms will have to rely on the revenue source that has traditionally supported their research efforts: the commissions that institutional investors pay for the execution of their stock trades. Unfortunately, this is a thinly-priced commodity business that can't cover the costs of running a large research department with a staff of highly paid analysts who require lots of expensive administrative and technological support. "They need to drive down their costs," says Sandy Bragg, executive managing director at Standard & Poor's Investment Services, a subsidiary of New York, N.Y., USA-based Standard & Poor's Corp.

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This restructuring process is already occurring — a few of the large firms have trimmed their research staffs as part of larger, across-the-board cutbacks — and further reductions in analyst positions are likely to occur. "They're going to run [their research operations] with a lot fewer people," says Brown. "They're going to run it with more inexperienced people." Compensation levels will most likely come down as well, and gone are the days when high-profile analysts such as Henry Blodgett — Merrill Lynch's former Internet guru who later became embroiled in the conflict-of-interest scandal — could earn a reported US$15 million a year.

Cutbacks at the big Wall Street firms will most likely create opportunities for independent research firms that avoid the conflict-of-interest issue because they don't offer investment-banking services. "All that has gone on in the market is an affirmation of why independent firms exist," says Gulliver at Jefferson Research.

Most independents operate on a completely different business model than their Wall Street counterparts. Boutique firms such as Jefferson typically sell their research to institutional investors for fees that can exceed US$100,000 a year. By keeping staff size down and paying modest salaries by Wall Street standards, they can survive on a revenue stream that would be just a fraction of the cost of running a huge research department at a major firm.

Even New York, N.Y., USA-based Sanford L. Bernstein — the largest independent firm in the United States — has a much different business model than the Wall Street houses. Bernstein, which does no investment banking, manages to support a staff of 45 analysts — 12 of whom are located in Europe — on trading commissions alone. In fact, Bernstein's analyst staff has more than *doubled* in the last three years. The difference between Bernstein and the Street firms, according to Chairman and CEO Lisa Shalett, is that her firm runs a low cost trading unit that focuses exclusively on customer needs, which requires less capital to support than a trading operation that takes proprietary risk. And with fewer commission dollars needed to support its trading effort, there's more left over for research. "We are in a completely different business," says Shalett.

Independent research is different in other ways as well. It tends to be more critical than research emanating from the major Wall Street firms, which have been loath to downgrade stocks in recent years. Jefferson Research, by contrast, specializes in companies with deteriorating financials and publishes what it calls Torpedo Alerts. "If we can't take apart a bullish Wall Street story, then we're not doing our job," says Gulliver. Although it does not focus on troubled companies per se, S&P isn't afraid to issue a sell rating — unlike most Street firms. Bragg says his team of 55 equities analysts issued 24 percent of all sell recommendations put out on stocks in 2002, according to a survey by Bulldog.com.

Independent research also tends to be more performance oriented, in large measure because institutional investors are actually paying for ideas. When institutional investors get stock research from the large brokerage firms as part of their trading commissions, they often ignore their recommendations. Indeed, a recent survey by *Institutional Investor* magazine showed that fund managers are more likely to use sell-side research to educate themselves about individual companies or industries than to pick stocks. It's quite a different matter with independent research. "Institutions hire us for our recommendations," says Thomas White, president of Chicago, Ill., USA-based Global Capital Institute. According to White, his analysts don't write lengthy reports or worry about earnings forecasts. Instead, the firm tries to isolate those financial ratios that most accurately predict a company's future performance, and then use that methodology to generate a list of buy recommendations.

And because investors are paying for performance in real dollars, independent firms feel enormous pressure to make their research better. "It makes our work more demanding," says Gulliver. "It makes our clients more demanding. We have to meet a higher standard than traditional Street firms."

In fact, the SEC's new requirement that the 10 Street firms make their recommendations public should ultimately impose a more demanding performance ethos on *both* sides of the equities research business. "Right now the mantra is 'independence,'" says Bragg at S&P, which licenses its research to the big Wall Street firms. "But over the long term it will be 'quality.'" And this should ultimately lead to compensation plans based on the quality of research rather than cooperation with investment bankers. "The very best people with performance are now getting paid the least," says White. "And the analysts with the very worst performance are getting paid the most."

Retail investors will clearly benefit from the SEC agreement, in part because each of the 10 Street firms will be required to purchase research from at least three independent firms over a five-year period and distribute these reports to their retail clients for free. And while the quality of sell-side research may gradually improve, the jury is out as to whether a smaller Wall Street research machine will benefit institutional investors.

Clearly there are some institutions that applaud the pact, including the California Public Employees' Retirement System (CalPERS). In a September 2002 letter commenting on AIMR's proposed research objectivity standards, Chief Investment Officer Mark Anson, CFA, wrote, "Sell-side research has become so conflict-ridden that CalPERS no longer relies upon the research recommendations of the sell-side brokerage firms. We currently discount sell-side research advice and rankings to account for the many inherent conflicts of interest."

But not everyone agrees with Anson's point of view. Hal Schroeder, a portfolio manager at New York, N.Y., USA-based Carlson Capital, typically ignores the buy-sell-or-hold recommendations of sell-side analysts, but values their research nonetheless because it's another important "data point" for him. "We do our own research, but we also look at everything out there that makes sense," he says. Brown, likewise, relies on sell-side analysts to keep himself informed even though Second Curve Capital has its own team of analysts.

A smaller, less experienced community of sell-side analysts may also mean less research *period* — creating a gap that the independents will be hard pressed to fill. "I think what institutional investors are going to lose is depth and variety of coverage," says Shalett at Bernstein. And if that's the case, hopefully quality will turn out to be more important than quantity.

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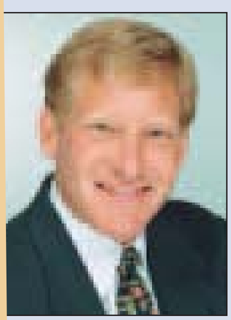
Bad for Business

One analyst's story of his fall from grace

Tom Brown was a highly regarded equities analyst at New York, N.Y., USA-based Donaldson, Lufkin & Jenrette and was the nine-time winner of *Institutional Investor* magazine's coveted award as the top-ranked regional bank analyst. But none of that mattered when Brown was summoned to his boss' office in March 1998 and fired because DLJ's investment banking team thought he was bad for business.



The problem was Brown's views on the mega-mergers then sweeping the banking industry. He had criticized many of those deals as bad for investors, and had publicly chastised one leading bank chief executive for being a "serial diluter." Credit Suisse First Boston, which later acquired DLJ, declined to comment on Brown's departure, although it stated two years ago that he was fired because of his "persistent inability" to operate with a team infrastructure. Brown says that's baloney. DLJ had just hired a new mergers and acquisition advisory team from a rival firm, and Brown claims the new guys wanted him fired as a condition of the deal. "They felt my views, particularly those critical of many of the acquisitions [that had been] announced recently by some large banking companies, would not be good for their business," he charges.

Brown has exacted his revenge. Now president of his own hedge fund — New York, N.Y., USA-based Second Curve Capital — Brown talked about his firing with the television news show *60 Minutes II*, which aired the interview in January 2001. Shortly after the segment ran, Brown says he received a call from the office of New York Attorney General Eliot Spitzer, who was already looking into ethical lapses on Wall Street. Brown says he had several meetings with Spitzer or members of his staff, and gave six hours of deposition. The attorney general's high profile investigation sparked a similar probe by the Securities & Exchange Commission, resulting in a landmark settlement agreement with the 10 largest securities firms on Wall Street.

Brown was not the only equities analyst who experienced firsthand the old adage that he who pays the piper calls the tune. And his dismissal in early 1998 shows that investment bankers were exerting pressure on their research colleagues — in this case to go easy on important corporate clients — long before the conflict-of-interest scandal erupted on Wall Street.

Brown says he is pleased with the SEC agreement, and even more pleased that the agency has continued to pursue individuals who allegedly broke the law through conflict-of-interest violations. And he's hopeful that sell-side analysts will now be free to do their jobs the way they should be done. But he's also bitter that so many of his former sell-side colleagues demonstrated a "lack of courage" when they buckled under to the demands of the investment bankers. "I was always critical of people who didn't have the guts to publish what they really thought," he says.